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NEW DELHI FOR A/S LASH FROM AMBASSADOR WILLS

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SUBJECT: SCENESETTER FOR THE VISIT OF COMMERCE A/S LASH TO SRI LANKA

Executive Summary

1. On behalf of the country team and the entire mission community, I extend to you a warm welcome in advance of your visit to Sri Lanka. Your visit comes at an exciting time, with the government of Sri Lanka (GSL) making real progress toward its twin goals of peace and economic development. This is also a time of heightened U.S. engagement with Sri Lanka on multiple fronts, including trade and commercial matters; your visit, following closely on the successful visit of Deputy USTR Jon Huntsman last month, is a strong sign of our commitment to greater engagement with GSL.

2. Sri Lanka now faces its best chance for peace in many years. A cease-fire has been in place since December 2001, and the government and Tamil Tigers just sat down for a third round of face-to-face talks, which are due to continue in the coming year. If GSL and the LTTE do reach a peace settlement, its efficacy and durability will depend largely on economic factors - specifically the extent to which Sri Lanka is able to achieve economic growth island-wide in the coming years. Strong growth will vest all Sri Lankans in peace; if growth falters, the government and the peace process will be especially vulnerable to domestic political pressures.

3. The U.S. is by far the largest trading partner of this trade-dependent nation, consuming nearly 40% of total exports in 2001. It is thus no exaggeration to say that the U.S. trade relationship plays a critical part in Sri Lanka's quest for peace. The Sri Lankans understand this, and they have been vocal about their desire to enter into FTA negotiations with us. We, for our part, see the Trade and Investment Framework Agreement (TIFA) signed with GSL in July as a platform for enhancing our bilateral trade relationship. As Deputy USTR Huntsman outlined during the first round of TIFA meetings here last month, we want to see GSL make real progress on economic reform and further opening its markets to U.S. goods. Making these tough choices is the best way to strengthen Sri Lanka's economy and bolster the chances for long-term peace.

4. I see two main areas where your visit can advance our trade interests here. First, your visit can promote U.S. exports by focusing the GSL's attention on the massive 10:1 trade imbalance between our two nations, and by discussing specific ways to right it. Second, you can encourage GSL to make the difficult economic reforms necessary to improve the investment climate here. I believe strongly that pursuing these goals with vigor will result in big benefits to U.S. business, not just in Sri Lanka but in South Asia as a whole. End Executive Summary.

Promoting U.S. Exports

5. The bilateral trade picture is dominated by a massive 10:1 trade imbalance in Sri Lanka's favor. The imbalance is mainly due to large Sri Lankan apparel exports to the U.S. (\$1.5 billion in 2001, or nearly 75% of total Sri Lankan exports to the U.S.) Sri Lanka's success in apparel manufacturing is partly attributable to a favorable deal on U.S. quotas, and partly attributable to Sri Lanka's success in positioning itself as a low-cost, reliable supplier to the upper-middle end of the U.S. retail sector (with The Limited, Inc., Liz Claiborne and Federated Department stores some of the major importers of Sri Lankan apparel). This success, however, has led to an over-dependence on the apparel sector for employment and economic growth. GSL knows it needs to diversify its export base; your visit will reinforce the message that improving the local investment climate (see below) is a necessary first step in achieving this diversification.

6. While the U.S. absorbs nearly 40% of Sri Lankan exports, our share of Sri Lankan imports is less than 4%. (Note: Main U.S. exports to Sri Lanka are wheat (35% of the

total), followed by yarns/fabric and electrical machinery. End Note.) Yet Sri Lanka runs an overall trade deficit of \$1 billion. It is importing plenty of goods, just not from the U.S.; main sources of Sri Lanka's imports are India (10%), Hong Kong (8%) and Singapore (7%). While this trend is due in part to stronger commercial and historical links with Asia, it is also due to a lack of transparency that disadvantages American suppliers.

17. I have been pushing GSL hard on every bid that comes up here, and have made good progress recently with significant power deals going the way of AES and General Electric. Still, there is a lot of business here yet to be won by U.S. companies. Your visit is an opportunity to put GSL on notice that we are keeping score, and that doing more for U.S. exports will help the overall trade relationship. Key areas where U.S. exports can be competitive are mass transit (buses, locomotive engines), power equipment, and textile fabric.

18. Sri Lanka flirted last year with a ban on biotech foods that would have set a precedent injurious to our global trade interests. This mission's aggressive lobbying, along with a strong letter from USTR Zoellick, helped convince GSL to drop the ban. Your visit is an opportunity to press GSL to keep its market open to biotech products and especially to steer clear of any harmful labeling schemes.

Improving the Investment Climate

19. Sri Lanka is eager to lure more U.S. investment to the country. Sri Lanka as a whole is under-invested, and U.S. investment here (book value) is a modest \$150 million. The ethnic conflict is only partly to blame; the local investment climate, while much better than elsewhere in South Asia, is far from perfect. Sri Lanka has the advantage of having opened its economy in the late 1970s, earlier than its neighbors. That wave of reforms led to a surge in foreign investment (mainly from Asia) and a rise in living standards in and around Colombo, where most of the investment was focused.

10. Twenty five years later, in spite of a long-running civil war, Sri Lankans enjoy the highest GDP per capita (\$850) of any nation in the region (except tiny Maldives). Now GSL stands on the brink of enacting a second wave of economic reforms that have the potential (against a backdrop of peace) to lead to unprecedented rates of economic growth. GSL has been vocal about what reforms need to take place - better protection of intellectual property, further privatization, shrinking of the regulatory role of government, more employer-friendly labor laws and improved transparency. Yet GSL has taken very little action, preferring to move with caution given the government's thin parliamentary majority and the fragility of the peace process. A downturn in economic growth or increase in joblessness - precisely the kind of short-term pain that reforms often produce - could leave GSL vulnerable to attack from a leftist/socialist party that can sway large numbers of voters.

11. GSL is right to be wary of moving too fast, but at the same time it cannot let another year slip by without taking steps to improve the investment climate. Your visit, in the context of the TIFA process, can give GSL the encouragement it needs to enact reforms decisively. Once the peace process is on solid footing, any delay in these reforms could endanger the prospects for foreign investment, and economic growth, for the rest of the decade.

Conclusion: South Asia and the Bigger Picture

12. With just 19 million of South Asia's 1.3 billion people, Sri Lanka would seem at first glance to form a small part of our overall trade interests with the subcontinent. But Sri Lanka is capable of playing a catalytic role in opening the region up to U.S. exports, and we can help it assume this role.

13. First, Sri Lanka can serve as an attractive entry point into South Asia for U.S. companies. Sri Lanka has an FTA in place with India, is currently finalizing one with Pakistan and plans to negotiate one with Bangladesh. These agreements are admittedly far from "free," being plagued by negative lists and restrictions on both sides. Yet they have the potential to make Sri Lanka into a hub for South Asian trade. The Indo-Lankan FTA, for example, would allow U.S. businesses to export products to Sri Lanka and re-export them (with local value-addition) to India on preferential duty terms. With import duties into Sri Lanka low and still high in other South Asian nations, these agreements mean Sri Lanka can act as an attractive gateway to a largely closed South

Asian market.

14. Second, Sri Lanka has the potential to act as a model for economic reform and open markets in the rest of South Asia. For 25 years Sri Lanka has been the region's most open economy. Now, especially if it is freed of the ethnic conflict that has hobbled growth, Sri Lanka can quickly become a force for liberalization in the region. We have seen in East Asia how small, dynamic economies such as Hong Kong and Singapore have prodded their larger neighbors toward greater economic openness. South Asia lacks a Hong Kong or Singapore; Sri Lanka can assume that role. Creating competition in liberalization in South Asia, with Sri Lanka leading the way, would go a long way toward promoting our regional trade interests.

WILLS